PBEs – Which Tier should we report in?

Now that the transition to the new Public Benefit Entity (PBE) accounting standards is fast becoming a reality some organisations are thinking about which tier they should be in. While the legislation and the accounting standards framework specify minimum requirements there is also choice for entities to opt up to other tiers should they wish to. This article explains key features of the tiers and explores why entities may wish to opt up.

The Decision

Which accounting framework tier a PBE falls into requires consideration of two main factors to be taken into account by the PBE's governing body. These are:

1. What the entity has to do – as specified by the now mandatory new accounting standards
2. What the entity then chooses to do over and above the mandatory standards and their reasoning as to why

What the PBE *has* to do

The minimum tier level a PBE will mandatorily fall into is determined by the concept of public accountability and the level of an entity's annual operating expenditure.

"Public accountability" in this context is a narrow accounting definition rather than a general English definition of this term. Essentially it is designed to capture PBEs that may be issuing debt securities to the public or whose primary activity is looking after cash or assets specifically for others such as banks, credit unions, insurance providers, securities brokers/dealers etc. As such it is highly unlikely to apply to most registered charities.

The term "operating expenditure" is used to determine the relevant tier and is defined by a standard called XRB A2 *Meaning of Specified Statutory Size Thresholds.* It is a very wide catch-all type of definition and includes the total amount of any expenses or payments (including grant payments) other than a capital payment made by the entity during the accounting period. This means it doesn't include purchase of fixed assets or repayment of a debt but will capture most other payments. Essentially it is trying to capture any expense that is required to be shown as an expense in the statement of financial performance.

Importantly for any registered charities that may also be philanthropic organisations, their operating expenditure includes any grants, donations, or distributions that they make to other organisations. Hence if they are making a grant or donation from funds they have invested under their control then this would be included in their total annual operating expenditure measure.

The tier level criteria are as per below, and as regards annual operating expenditure should be considered over a two year period i.e. it would need to be above the level for two years before an entity would need to change up a tier:

TIER 1	TIER 2	TIER 3	TIER 4
Full PBE Standards	PBE Standards with Reduced Disclosure Regime	Simple format report: ACCRUAL	Simple format report: CASH
Over $30 million annual operating expenses	Less than or equal to $30 million annual operating expenses	Less than or equal to $2 million annual operating expenses	Under $125 000 annual operating payments
Or has public accountability	And without public accountability	And without public accountability	And without public accountability

Key features of each tier

Tier 1: The most complex accounting standards suite. 38 separate standards derived largely from International Public Sector Accounting Standards (IPSAS). No disclosure reduction exemptions available. These suite of standards are similar in nature to International Financial Reporting Standards but with a PBE focus.

Tier 2: The same 38 standards as Tier 1, however Tier 2 entities are allowed to apply Reduced Disclosure Regime exemptions (RDR). This means they must apply the same recognition and measurement criteria but are allowed to take advantage of significantly reduced disclosure requirements.

Tier 3: The standard consists of a single simple format reporting standard to provide for accounting on an accruals basis. Significantly different from the IPSAS derived standards as this was written from scratch in New Zealand and with a policy override of good accounting but that benefit must outweigh cost. The total standard is 58 pages long.

Tier 4: The simplest accounting standard allowing cash accounting as may be appropriate for very small entities.

There is quite a substantial difference in complexity between Tiers 1 & 2 and Tiers 3 & 4. As a general observation most PBEs moving to Tier 1 or 2 will have more complex accounting to follow whereas most moving to Tier 3 or 4 will find the accounting requirements simpler than their current treatment. We do stress however that this is a very general comment. Depending upon the specific nature of the organisation and their past accounting there may be exceptions to this.

As noted above Tiers 3 & 4 have been written in NZ from a blank sheet whereas Tiers 1 & 2 standards consist of 38 separate accounting standards. However it is important to note that not all of these 38 standards will apply in every case. In fact in most cases we have looked at to date at least a third, or sometimes more, of these standards generally won't apply. This is because the organisation involved simply does not have transactions in the areas covered by those particular standards. For example if a PBE doesn't deal in foreign exchange, or isn't involved in construction contracts, then they can simply ignore the Tiers 1 & 2 standards on those areas. As such the complexity of a set of financial statements and reporting under Tiers 1 & 2 is widely variable, from the complex to the relatively simple. It depends upon the complexity and mix of areas of operation of the individual organisation and the accounting required for these.

What the PBE *chooses* to do

Working through the above an entity should be able to determine by law which accounting standard suite they are required to follow as a minimum. However unless the entity is already at Tier 1 the choice to opt up to a higher standard set is always open to them. (To be technically correct all entities default to Tier 1 and then the governing body can elect to adopt another tier as long as they meet the relevant criteria). Reasons why a PBE's governing body may voluntarily choose to do this include:

a. Their expectation of growth and that their total annual operating expenditure will shortly be over the threshold of the next Tier up. Accordingly the entity may want to avoid transitioning from their existing accounting to a Tier only to have to shortly change to a higher Tier.

b. A strategic view that a Tier above is a higher level of accounting sophistication. As such it demonstrates a more sophisticated level of governance that may be expected by or positively received by some of their key stakeholders such as significant donors.

c. Seeking more detailed accounting information by choosing to use the more complex standards. This may enable more detailed oversight by management and the governing body. An example is an entity that manages quite complex investments may want the greater precision and disclosure of accounting for these under the IPSAS derived accounting standards.

What cost?

Quite simply; more complex accounting costs more.

However in our experience the level of cost differential will vary widely depending upon the specific features of the entity concerned, the complexity of their operations from an accounting perspective, and their level of internal resources to handle the required accounting.

Hence a key question for entity governing bodies is striking the optimum balance between the attraction of cost effectiveness and the expectations of their key stakeholders and donors.

Can we have a bit of both?

Just to throw a further compromise option into the mix; it is allowable for an entity to adopt say Tier 3 but then to choose to opt up in certain specific areas of accounting to a higher Tier. This can be done if it is felt that the more complex accounting standard in that particular area would be more useful for their governance and management as well as better meeting the expectations of key stakeholders. For example given the importance of investments to some PBE entities they may choose to adopt the Tier 2 accounting standard as regards the recognition and measurement of investments. This would allow them to value their investments at their market value. This also requires more disclosure about the investments which may be very useful for readers.

The proviso for opting up for a certain accounting standard is that it then must be applied consistently to all items/transactions of that nature i.e. an entity cannot cherry pick to apply the higher accounting standard just for some investments and can't return to applying the Tier 3 Standard for that transaction. Rather it would need to be applied in its entirety to all investments. The financial statements would also need clear disclosure to let readers know what had been done and which standards were being applied to what.

Summary

All PBEs will have to transition to new accounting standards for their 2016 year end (unless they have already early adopted). Accordingly it is important they are aware of what minimum Tier they are required to apply by law.

However we also suggest it timely to consider if this mandatory Tier will in fact best meet their practical and strategic needs, as well as expectations of key stakeholders, before the transition is commenced.

About the Author

Craig Fisher FCA is an Audit Partner and Chairman of RSM. Craig is a specialist regarding not-for-profit and charitable entity issues.

Contact Craig on:
D: +64 (9) 367 1654
E: craig.fisher@rsmnz.co.nz
W: www.rsmnz.co.nz